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The European Central Bank's recent monetary policy decisions

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Pablo Hernández de Cos, Governor of the Banco de España.

I am honoured to contribute to this special anniversary edition of *Expansión*. I would like to take this opportunity to explain the monetary policy decisions taken on 4 May by the Governing Council of the European Central Bank (ECB).

As is well known, the ECB's mandate is to maintain price stability in the euro area. This is defined as a medium-term inflation target of 2%. In response to the escalation of inflation pressures from the summer of 2021 and an above-target medium-term inflation outlook, in late 2021 we began the process of normalising and subsequently tightening our monetary policy.

Our decisions in May represent a further step in this process. In particular, we raised our interest rates by 25 basis points (bp), which brought the deposit facility rate to 3.25%, making a cumulative increase of 375 bp since July 2022.

This decision was based on our overall assessment of the three essential factors currently informing our interest rate policy: (i) the inflation outlook in light of the incoming economic and financial data, (ii) the dynamics of underlying inflation and (iii) the strength of monetary policy transmission.

As regards the first factor – the inflation outlook – our assessment largely rests on the Eurosystem staff quarterly projections. The latest projections, published in March, forecast a gradual decline in inflation to levels very close to the 2% target by the end of the projection horizon. This projection was based, among other assumptions, on market expectations for our interest rates, which envisage the deposit facility rate peaking at around 3.75% in the coming months.

No new projections were released in May. However, based on the incoming data it was our view that the March projections essentially remained valid. In particular, economic activity performed in line with the projections (for instance, GDP grew by 0.1% quarter-on-quarter in 2023 Q1 while the labour market remained robust); in April inflation stood at 7%, slightly higher than expected; financial conditions tightened further, above all as a result of the euro's continued appreciation; and energy prices were somewhat lower than those assumed in the March projections.

Turning to the second factor, in April underlying inflation (which excludes energy and food) stood at 5.6%, higher than projected in March. Other indicators bear out the continuing strength of underlying price pressures. Wage pressures have mounted further and firms in some sectors have continued to increase their profit margins. In addition, although most medium and long-term inflation expectation indicators stand at around 2%, some have risen and will have to be monitored closely.

There are doubts over the last of our three factors – the strength of monetary policy transmission –, given that, among other aspects, the pace of interest rate hikes in this cycle is unprecedented in the euro area. The latest data show that the transmission to financial and monetary conditions is proving to be forceful, while the strength of, and lags in, transmission to the real economy remain uncertain. For instance, the latest Bank Lending Survey points to a sharp tightening of credit standards for firms and households in 2023 Q1, beyond what was expected a quarter earlier. This is in addition to the tightening seen in previous quarters.

In light of this evidence, with a medium-term inflation outlook similar to that of March, strong underlying price pressures and confirmation that our interest rate increases are being transmitted forcefully to financing conditions, we decided to raise interest rates by 25 bp. This increase was smaller than the previous ones given that the monetary policy tightening process is already well under way, so that larger hikes were not necessary.

Looking ahead, we will continue to base our decisions on the incoming data and, in particular, the three factors mentioned above. In any event, we must ensure that interest rates will be brought to sufficiently restrictive levels to achieve a timely return of inflation to the 2% medium-term target and will be kept at those levels for as long as necessary.

We also announced further steps to reduce the size of the Eurosystem's balance sheet. This contributes to tightening financing conditions, especially through medium and long-term interest rates, and therefore complements the interest rate increases, which are our primary tool for setting the monetary policy stance. In early March we began the process of reducing the size of the asset purchase programme, at a pace of €15 billion per month up to June, by not reinvesting all of the principal payments of maturing securities. In May, we announced that we expect to discontinue these reinvestments from July 2023.

To conclude, the ECB is acting decisively to bring inflation back to the 2% target in the medium term. Clearly, there are short-term costs to this process in terms of weaker economic activity. However, maintaining price stability is the main contribution that a central bank can make to ensure sound economic growth in the long term.